Risk Reward
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New Standards for Risk Management

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TRADE FINANCE - LOWER THE RISK AND INCREASE THE REWARD!

Mike Skelton is a banker with over thirty years knowledge and experience in trade finance and international trade related practices and procedures which he has gained by working in the trade operations, sales and training divisions of Midland HSBC, NatWest, Royal Bank of Scotland and Barclays. In this article he explains the fundamentals and essential value of trade finance at a time when many banks and financial institutions worldwide are more active than ever in this field of activity.

Trade finance has stood the test of time - it has been around for thousands of years, with historians tracing the concept back to the Ancient Roman Empire where factoring and invoice discounting was used by money lenders as a means of financing trade transactions between local merchants, traders and warehouse owners.

In the 1800s trade finance really came of age as a result of the growth and development of trade and relations between countries in Europe, in particular China and India. On the back of this steady increase in cross-border trading activity a number of European banks made a strategic decision to capitalize on what they believed to be a remunerative and sustainable income generation opportunity. They did this by opening branches in China and India with the objective of supporting the buying and selling of commodities including silk, cotton, rice and tobacco (even opium!) using trade finance techniques and mechanisms that are still used today by banks worldwide.

These days, the use of trade finance practices and procedures is by no means restricted to trade flows between two particular geographical areas of the world. Indeed, banks and financial institutions globally use trade finance as a tried and tested **low risk** and **highly remunerative** alternative to conventional working capital facilities.

As the financial sector begins to move slowly out of the global recession it is very clear that banks and financial institutions around the world are revisiting and revising their lending strategy and criteria for both existing and potential new customers.

The whole of the global banking and finance sector has recently been deluged with bad publicity about sub-prime lending and associated toxic debt, the collapse and bailout of a number of high street institutions, global financial meltdown, the credit crunch and subsequent negative/restrictive trading impact on hundreds of trading businesses around the world.

All these factors, coupled with reduced levels of liquidity and confidence in the inter-bank markets, have resulted in money becoming a scarce resource with banks and financial institutions seriously scrutinizing their risk/reward return on individual lending propositions more than ever.

This renewed caution within the global financial sector, partly due to the factors mentioned above, has resulted in fewer credit applications and proposals for both existing facility renewals and new money being presented by banks/financial institutions for sanction, and ultimately a decline in the number of actual requests being agreed and signed-off by credit committees.

Using trade finance techniques instead of traditional working capital finance facilities e.g. 'pot' finance or overdraft, greatly enhances a bank/financial institution's risk/reward profile by providing additional comfort gained through transactional control, along with additional fees and commissions earned by adopting integrated financing solutions using classical trade finance products, such as documentary credits and collections.

Unlike with traditional working capital solutions, in a typical trade finance deal it is possible to break trade related business into its constituent parts and thereby gain a better view of potential areas of risk. Structured loans can be used in place of 'pot' finance or overdrafts which, whilst offering the customer maximum flexibility, are also open-ended from a risk perspective e.g. they can be used to finance the purchase of items not related to the core trading business of the customer. Trade finance structured loans typically have specific limits and maturity dates set to coincide with the customer's cash flow generated by the sale of goods.

The reality is that trade finance structures offer banks/financial institutions considerable advantages over and above traditional working capital facilities:

- Using trade finance instruments (e.g. bills of exchange, promissory notes, documentary collections and documentary credits) in conjunction with structured loans enables a bank/financial institution to exercise transactional control and fully maximise risk mitigation opportunities throughout the customers trade cycle.
- Trade finance facilities are closely matched to the customer's actual funding requirements and trade cycle in line with each individual trade transaction.
- Unlike conventional 'pot' finance/overdraft, the funds advanced to the customer are provided for a specific purpose and cannot be easily diverted into supporting general working capital or indeed financing losses.
- Repayment of facilities is directly linked to the sale of underlying goods on an individual invoice by invoice basis. Any delay in repayment of a structured loan at maturity provides the bank/financial institution with an early warning of potential customer liquidity problems.
- Structured facilities increase the quality and quantity of account information for banks/financial institutions which improves overall credit quality through an enhanced ability to monitor risk.
- In certain circumstances the bank/financial institution might have a prior security interest in the goods financed using a trade finance structure, enabling them to easily identify, take possession of and sell the underlying goods if necessary to repay the loan/facilities.
- The increased levels of comfort which banks/financial institutions can acquire through trade finance techniques coupled with the ability to 'make more money', should arguably have a more positive effect on the willingness to make credit facilities available to customers involved in international trade versus the provision of traditional 'pot' finance or overdraft facilities.

In conclusion, it is fair to say that even during times of global economic recession and financial meltdown, trade finance remains the solution that can offer banks/financial institutions both a **lower risk** and **higher reward** lending proposition.

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